THE FRAUDULENT TRADING OFFENCE: NEED FOR A RELOOK

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The main focus of the article is on the effectiveness of the criminal sanctions for fraudulent trading as a creditor protection mechanism. The article begins with an examination of the evolution of the duty of directors towards the creditors of the company. Then it seeks to address the main arguments advanced for and against penalising fraudulent trading. This is followed by an analysis of the fraudulent trading provision in India and UK. The study reveals that the provision has failed to achieve its purpose of punishing rogue managers and lax directors. It points out the flaws in the Indian law and proposes some suggestions to overcome the same. The main questions addressed in this article include: Who has a duty to prevent insolvent trading? When is the duty triggered? When can the company be said to be insolvent? And finally what is the scope of the duty to prevent insolvent trading?

I. INTRODUCTION

Corporate bankruptcies among companies such as Enron, Worldcom and Paramlat have brought into focus the directors duty to prevent fraudulent trading. Today corporate failure is viewed as a problem resulting from corporate mismanagement. The law has to provide incentives to minimize the likelihood of corporate failures. Liability for fraudulent trading is one mechanism intended for deterring improper conduct by corporate managers and directors.

The incurring of debts in circumstances where there are reasonable grounds for suspecting that a company would be unable to pay its debts is referred as fraudulent trading. Directors shall take into consideration the interests of creditors during the times of financial distress. Where the company becomes insolvent, it may be put into liquidation or some kind of formal insolvency procedure to protect the creditor's interests. Rescue operations aimed at reviving the business may also be undertaken. If the directors continue trading as usual it can cause potential harm to the creditors. Fraudulent trading provisions seek to address such illicit trading by directors and managers of the company.[1]

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[1] Thomas Bachner, *Wrongful Trading– A New European Model for Creditor Protection*, 5 E.B.O.R. 293 (2004).

The intention behind a fraudulent trading provision is to require directors to take action to prevent their company from falling into insolvency. Directors shall rigorously monitor their companies' financial condition. Wrongful trading provisions are intended to address the situation where directors are aware that their company is in difficulty and they do nothing to protect creditors' interests. They are intended to engender in directors of companies experiencing financial stress a proper sense of attentiveness and responsible conduct directed towards the avoidance of any increase in the company's debt burden. The provisions are based on a concern for the welfare of creditors exposed to the operation of the principle of limited liability at a time when the prospect of that principle resulting in loss to creditors has become real.[2] Liability for fraudulent trading is an important exception to the limited liability principle.

The focus of this paper is on the accountability of corporate directors and managers for fraudulent trading and on the role of criminal law in holding them responsible for their excesses. The first part traces the evolution of the duty of directors of companies in financial distress. This is followed by arguments raised for and against the imposition of criminal liability for fraudulent trading. It examines whether the offence of 'fraudulent trading' serves the purpose of deterring the controllers of the company from violating their duty to prevent fraudulent trading. The last part gives an overview of the fraudulent trading provision in India and makes a comparative analysis with the respective provision in the UK. It concludes by pointing out the flaws in the Indian law with respect to fraudulent trading and proposes some suggestions to overcome the inadequacies identified.

II. RISKS FACED BY CORPORATE CREDITORS

Before analyzing the risks faced by corporate creditors it would be worthwhile to discuss the various categories of corporate creditors. Corporate creditors can be categorised into voluntary creditors and involuntary creditors.[3] Creditors who voluntarily enter into relationship with the corporation are called voluntary creditors or consensual creditors. They include trade creditors, institutional lenders, employees and debenture holders. Trade creditors supply goods and services to the company and advance credit by not requiring immediate payment. Banks are the most important group of institutional lenders. Overdraft extended by banks allows the company to borrow by overdrawing on a bank account. The company pays the money due by periodically making

[2] *Id*. The privilege of limiting liability for corporate debts is one of the principles of doing business under the corporate form of organization. The shareholders liability shall be limited to the nominal value of shares taken by them or guaranteed by them. No member is bound to contribute anything more than the value of shares taken by them.

[3] Peter O. Mulbert, *A Synthetic View of Different Concepts of Creditor Protection*, *or*: *A High-Level Framework for Corporate Creditor Protection*, 7 E.B.O.R. 357, 365 (2006).

deposits in the bank account. Employees lend human capital to the company. They are creditors of the company to the extent of money owed to them for wages and other benefits. The standard way in which a company borrows money is by means of issuing debentures. A debenture is a certificate of loan issued by the company. Creditors can also be categorised as secured creditors and unsecured creditors on the basis of whether a charge is created over the assets of the company while lending money to the company. Involuntary creditors or the non-consensual creditors include the state as tax creditor, other public agencies and tort creditors.

The protection of voluntary creditors has been the main concern of company law ever since the introduction of the limited liability principle. As a consequence of the principle of limited liability, the shareholders are not personally liable to creditors for corporate debts. The limited liability principle has been widely criticized on the ground that it encourages excessive risk taking at the expense of creditors.[4] Limited liability directly contradicts the goal of deterrence and punishment.[5] Tort victims are the real risk bearers of limited liability.[6] Corporate creditors face a high risk of non-performance by the debtor. Controllers may use their power to serve their own economic or financial purpose. They may use decision making power opportunistically to the prejudice of other stakeholders whose interests depend on the economic fortunes of the company. Corporations may become insolvent on account of wrongful trading, opportunistic behaviour on part of corporate directors or as a result of a genuine business failure. The primary interest of a creditor is in being repaid when the debt is due. The main risk faced by a creditor is that the debtor will not have sufficient funds when payment is due. The possibility that a corporate debtor will fail to meet its debt obligations is referred to as default risk.[7] Creditors face high risk when controllers carry on a high risk strategy to get over a crisis. If the strategy fails the condition of the creditor will become worse. It becomes a typical case of wrongful trading. The controllers of the company may siphon off company assets into their hands. The controllers make payments to certain creditors especially themselves in preference to other creditors.

Creditor protection had to be the main concern of law if the companies are to survive as a business form. The legal system need to protect corporate creditors to encourage lending. The protection of corporate creditors is based on ethical considerations and notions of fairness.[8] The creditors need to be protected against the controllers of the company who have the power to

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4 Hansmann & Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, (1991) 100 YALE L.J. (1879).

5 Cooper Alexander, *Unlimited Shareholder Liability through a Procedural Lens*, 106 HARV. L. REV. 387, 390 (1992).

6 *See* Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565 (1991).

7 BRIAN R. CHEFFINS, COMPANY LAWS: THEORY, STRUCTURE & OPERATION 69 (1997).

8 Andrew Keay, *Directors' Duties to Creditors*: *Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors*, 66 MLR 665, 677 (2003).

take decisions on behalf of the company.[9] Realizing the risks faced by corporate creditors many creditor protection devices like the doctrine of capital maintenance,[10] minimum capital rule, the *ultra vires* doctrine[11] and the disclosure requirements were included in the company law regime.[12] The prohibition on fraudulent trading was devised as a mechanism to prevent opportunistic behaviour by corporate debtors to the detriment of the creditors.[13]

III. EVOLUTION OF THE DUTY TOWARDS CREDITORS

Courts have been reluctant to hold that directors must have regard to the interests of the creditors.[14] There was a shift in approach in the 1980s. The development of directors' duties to creditors where the company is financially distressed can be traced to the comments of Mason J. of the Australian High Court in *Walker* v. *Wimborne*[15] where it was observed that: "In this respect it should be observed that the directors of the company in discharging their duty to the company must take into account of the interests of its shareholders and creditors. Any failure by the creditors to take into account the interests of creditors will have adverse consequences for the company as well as for them."[16]

The first English case to consider the duty of directors towards creditors was that of *Lohnro* v. *Shell Petroleum Co. Ltd*.[17] wherein it was stated that the best interests of the company does not mean the interests of the shareholders exclusively but may include interests of its creditors. In *Winkworth* v. *Edward Baron Development Co. Ltd*.,[18] Lord Templeman opined: "A duty is owed by the directors to the company and to the creditors of the company to

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9 Thomas Bachner, Creditor Protection in Private Companies: Anglo-German Perspectives for a European Legal Discourse 21 (2009).

10 Paul L. Davies, Gower's Principles of Modern Company Law (1997). The rules emanating from the doctrine of capital maintenance are that the company shall not purchase its own shares, a company shall not give any kind of financial assistance to any person for the acquisition of its own share and that dividends must not be paid to the shareholders except out of distributable profits.

11 *See* Dr. L. C. Dhingra, *Doctrine of Ultra Vires in Company Law*, 17 Comp LJ (J) 27 (1992). Any activity which is not expressly or impliedly authorized by the statute or by the list of objects in the objects clause is *ultra vires* or beyond the powers of the company. The doctrine protects creditors by ensuring that the company's funds to which they must look for payment are not dissipated in unauthorised activities.

12 Mulbert, *supra* note 3.

13 *See* Gerald Spindler, *Trading in the Vicinity of Insolvency*, 7 E.B.O.R. 339 (2006).

14 Adolf A. Berlie, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 279 (1932).

15 (1976) 3 ACLR 529.

16 *Id*., 532.

17 [1980] 1 WLR 627 (H.L.).

18 [1987] 1 All ER 114.

ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited to the prejudice of the creditors."[19]

Notwithstanding the broad statements made in the above judgments, in the cases that followed, courts took the view that the duty to protect the interests of creditors arises only when the company is insolvent.[20] So long as the company remains a growing concern the company's best interests may be served by having regard to the interests of its members. If the company's capital has been lost, the members have no financial interest in the company. In those circumstances the directors must have regard to the interests of debenture holders and other creditors. If the directors continue the company's business while it runs into insolvency, they may be found guilty of fraudulent or wrongful trading.

Judicial opinion is divided as to the circumstances which will cause directors to consider creditor's interest.[21] In *Nicholson* v. *Permakraft* (*NZ*) *Ltd*.,[22] the court held that creditors interests are entitled to consideration if the company is insolvent, or near insolvent or of doubtful insolvency or if a contemplated payment or other cause of action would jeopardize its solvency. In answering the question 'from which point of time the duty of director's to take care of the interests of creditors intrude', it was held in *Brady* v. *Brady*[23] that creditor's interests shall take predominance in circumstances of insolvency or doubtful solvency. Where it is shown that the company is solvent and able to pay its debts as they fell due the creditor's interest shall not be considered as

19 *Id*., 118.

20 Liquidator of West Mercia Safetywear Ltd. v. Dodd, (1988) 4 BCC 30.

21 *See* Keay, *supra* note 8, 11; Hawke, *Creditor's Interest in Solvent and Insolvent Companies*, J.B.L. 54 (1989).

22 (1985) 3 ACLC 453.

23 [1988] 2 All ER 617 (H.L). The issue for consideration in the case was whether financial assistance provided to the subsidiary company to reduce subsidiary's liability to the parent company was *ultra vires* .Court held that the transaction was not *ultra vires* as the assistance had been provided 'in good faith in the interests of the company'. A family business was proposed to be divided into half following disagreement between the two brothers who operated the business. A new company was formed wholly owned by one of the brothers. This company acquired shares in the original company against loan stock representing half the value of the assets of the original company. This loan stock was issued but there were no assets in the new company. Thereafter the loan stock was redeemed by the original company through a transfer of half its assets to the new company. One of the brother's later alleged that the original company's net assets were undervalued so that he had suffered a huge loss. When he refused to proceed with the arrangement the other brother initiated proceedings for specific performance. The issue for consideration before the court was whether the company's provision of financial assistance to the new company for the acquisition of its shares through the redemption of loan stock issued by the new company was contrary to §151(2) of the Companies Act, 1985. To save the transaction, it had to fall within the exception provided by 153(1)(b) where "… the assistance is given in good faith in the interests of the company". The court found that the proportion of assets being removed was so large that it was essential for the question of creditor's interests to be addressed.

least affected.[24] Given that during insolvency the company will be effectively trading with the creditors' money, the creditors become the major stakeholders in the company and are in effect the real owners of the company. Hence the creditors warrant some form of fiduciary protection. The doctrine of limited liability shifts the risk of failure from the shareholders to the creditors which can be mitigated by imposing a duty to take account of creditor's interest.[25]

The insolvency based duty-shifting approach is well settled principle In the United States also.[26] In *Credit Lyonnais Bank Nederland*, *N.V.* v. *Pathe Communications Corp*.,[27] a Delaware court held that where a corporation is operating in the vicinity of insolvency, the board of directors shall owe its duty to the corporate enterprise and shall not act as mere agents of the residue risk bearers. In a solvent situation the shareholders are the residue risk bearers. When the company is solvent directors owe fiduciary duties to the company which is equated with the interest of the shareholders. As the company becomes insolvent, the creditors become the residue risk bearers and the interest of the company can be equated with the interest of the creditors.

The legal system imposes additional responsibilities on company directors where the company approaches the zone of insolvency or financial distress. Continued trading can cause serious harm to the creditors. When a company reaches some stage of financial distress the duty of directors shall shift from a focus on the interests of shareholders to that of creditors. If the directors of a company in liquidation are shown to have failed to take steps which they ought to have been taken to minimize loss to the company's creditors they may be held liable for wrongful trading and required to make personal contribution to the company's assets.[28] Specific transactions entered into during the twilight zone[29] and which are prejudicial to creditors such as transactions at undervalue,[30] preferences[31] and transactions with intend to defraud creditors are liable to be set aside.

Insolvency triggers the duty to prevent insolvent trading. The law imposes certain restrictions on specific forms of undesirable conduct by the directors and managers of the firm. Directors shall take some precautionary measures in times of difficulty. If the directors continue trading regardless of

24 *Id*., 632.

25 Keay, *supra* note 8, 386.

26 *See* Lipson, *The Expressive Function of Director's duties to Creditors*, 12 Stanford Journal of Law Business and Finance 5 (2007).

27 1991 WL 277613 (Del. Ch. 1991).

28 The Insolvency Act, 1986 (UK) §214.

29 The 'twilight zone' is the term used to describe a period of trading when a company has or is predicted to have insufficient cash to pay its debt. *See* David Milman, *Strategies for Regulating Managerial Performance in the 'Twilight Zone'-Familiar Dilemmas*: *New Considerations* 2004 J.B.L. 493.

30 The Insolvency Act, 1986 UK, §238.

31 *Id*., §239.

the fact that the company is insolvent, it may invite civil as well as criminal sanctions. The law does not require that a company that finds itself insolvent must stop trading and be wound up as soon as possible.[32] Now the emphasis is on corporate rescue and which requires that every viable business should be continued.[33] No guidelines on what shall be the appropriate response of the managers to a crisis situation can be laid down. What needs to be done in each case will depend on the facts and circumstances of each case. The directors should take active steps to revive the company. The managers may seek professional advice on how to address the difficulties faced by the company. If the directors disregard the 'warnings' from the professional advisers they may be found guilty of wrongful trading.

In articulating the scope and ambit of the duty to protect the interests of creditors, it is might be impossible for the courts to give clear guidelines on the dos and don'ts in the twilight zone. An ex-post examination of whether the acts of directors were detrimental to the interests of the creditors is perhaps the only way out.

IV. LIABILITY FOR FRAUDULENT TRADING

The directors of a company that has gone into insolvent liquidation can face many consequences. Fraudulent trading and/or wrongful trading proceedings can be initiated against them.[34] Directors involved in wrongful trading can be ordered to contribute to the funds of the company.[35] They can also be disqualified from acting as a director for up to 15 years.[36] Misfeasance proceedings may also be initiated against the directors.[37] These actions are administered by the civil courts. The directors may also be subject to criminal liability and sentenced to imprisonment.[38]

Criminal liability for fraudulent trading is justified because fraud needs to be deterred. Fraudulent trading provisions protect creditors from the abuse of the limited liability principle. The limited liability principle enables the directors to externalize the risk to creditors. It creates incentives for directors to make investment in high risk projects. The duty to prevent fraudulent trading imposes an obligation on directors to take into consideration the

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32 Goode, Principles of Corporate Insolvency Law 472 (1997).

33 Hunter, *The Nature and Functions of a Rescue Culture*, J.B.L. 491 (1999).

34 The term 'fraudulent trading' is used in criminal proceedings initiated against directors for trading while the company is insolvent whereas the term 'wrongful trading' is used in civil proceedings initiated for an order directing directors to contribute to the funds of the company.

35 Insolvency Act, 1986 (UK) §214.The section does not use the term 'wrongful trading'. It is only used in the title to the section.

36 The Company Directors Disqualification Act, 1986 (UK) §6.

37 The Companies Act, 1956, §543.

38 The Companies Act, 2006 (UK) §993 and the Companies Act, 1956, §542.

interests of creditors when the company is in financial difficulties. Liability for fraudulent trading is justified because it is necessary to prevent unreasonable gambling with money that would have otherwise gone to the creditors upon the dissolution of the company.[39] When a company is insolvent, it is trading with the creditor's money. Creditors are the ones who suffer loss if the company collapses. If the directors employ funds that are payable to creditors improperly to continue the activities of the company, they are to be made accountable. The existence of criminal liability might encourage directors to be more prudent and discourage them from undertaking risky ventures.

Civil liability for fraudulent trading does not serve the deterrent and preventive objective of proscribing fraudulent trading. Making the directors contribute to the funds of the company does not provide sufficient incentive for the directors to desist from indulging in irresponsible trading. Another major limitation with regard to imposing civil liability on directors for fraudulent trading is that only the directors of companies that have gone into liquidation are made liable. Companies that have been rescued by the government by injection of capital or taken over by another company will never go through the liquidation proceedings. In such cases it is doubtful whether any fraudulent trading proceedings will ever be initiated against the rogue directors who had mismanaged the affairs of the former company. Disqualification also is not an effective deterrent in preventing fraudulent trading.[40] Disqualification has only a marginal effect in improving the behaviour of directors. Hence it is essential that fraudulent trading be backed by criminal sanctions so as to deter the directors from indulging in wrongful trading. The purpose of criminal sanctions in fraudulent trading cases is also to deter directors of similar companies in financial difficulties from resorting to dishonest trading and borrowing.

The argument that fraudulent trading should not be penalized is equally strong. Those who oppose insolvent trading provisions argue that it has the effect of making directors unduly risk-averse.[41] Risk taking is a significant factor in promoting economic growth. There is a danger that businesses will be closed down too early by putting companies into voluntary administration or liquidation for fear of personal liability.[42] Such provisions can also deter qualified people from becoming managers. Insolvent trading provisions would inhibit investments that are risky, but are profitable.[43] Liability for insolvent

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39 *Supra* note 15.

40 Andrew Hicks, *Director's Disqualification*: *Can it Deliver?*, J.B.L. 433 (2001). The article refers to an empirical study wherein it was found that the threat of disqualification never influenced the directors as to how they ran the business.

41 *Id*.

42 *See* Cooke & Hicks, *Wrongful Trading- Predicting Insolvency*, J.B.L. 338 (1993).

43 Whincop, *Taking The Corporate Contract More Seriously*: *The Economic Cases Against*, *and a Transaction Cost Rationale for Insolvent Trading Provisions*, 5 Griffith Law Review 1, 28 (1996).

trading over compensates the creditors because they are already paid for the risk undertaken by means of the contractual agreement.[44]

V. INDIAN POSITION

Fraudulent conduct of business is a criminal offence in India. Where any business of the company is carried on with the intent to defraud creditors, every person who was knowingly a party to the carrying on of the business shall be punishable with imprisonment and fine.[45] The Companies Bill, 2009 proposes to enhance the punishment for fraudulent trading with imprisonment which shall not be less than one year but which may extend to three years and with fine which shall not be less than one lakh but which may extend to three lakhs.[46] The civil and criminal liability for the fraudulent conduct of the business is provided under the same provision. The civil liability envisaged by the section is independent of any criminal liability arising under the section.

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44 *Id*.

45 The Companies Act, 1956, §542: Liability for fraudulent conduct of business: (1) If in the course of the winding up of a company, it appears that any business of the company has been carried on, with intent to defraud creditors of the company or any other persons, or for any fraudulent purpose, the Court, on the application of the Official Liquidator, or the liquidator or any creditor or contributory of the company, may, if it thinks it proper so to do, declare that any persons who were knowingly parties to the carrying on of the business in the manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct. On the hearing of an application under this sub-section, the Official Liquidator, or the liquidator, as the case may be, may himself give evidence or call witnesses.

(2)(a) Where the Court makes any such declaration, it may give such further directions as it thinks proper for the purpose of giving effect to that declaration.

(b) In particular, the Court may make provision for making the liability of any such person under the declaration a charge on any debt or obligation due from the company to him, or on any mortgage or charge or any interest in any mortgage or charge on any assets of the company held by or vested in him, or any person on his behalf, or any person claiming as assignee from or through the person liable or any person acting on his behalf.

(c) The Court may, from time to time, make such further order as may be necessary for the purpose of enforcing any charge imposed under this sub-section.

(d) For the purpose of this sub-section, the expression "assignee" includes any person to whom or in whose favour, by the directions of the person liable, the debt. obligation, mortgage or charge was created, issued or transferred or the interest was created, but does not include an assignee for valuable consideration (not including consideration by way of marriage) given in good faith and without notice of any of the matters on the ground of which the declaration is made.

(3) Where any business of a company is carried on with such intent or for such purpose as is mentioned in sub-section (1), every person who was knowingly a party to the carrying on the business in the manner aforesaid, shall be punishable with imprisonment for a term which may extend to two years, or with fine which may extend to five thousand rupees, or with both.

(4) This section shall apply, notwithstanding that the person concerned may be criminally liable in respect of the matters on the ground of which the declaration is to be made.

46 The Companies Bill, 2009, §314.

Criminal proceedings for fraudulent trading can be initiated by the liquidator with the sanction of the Company Law Tribunal. The tribunal cannot pass any penal order of punishment for fraudulent trading.[47] The tribunal can only give permission to the official liquidator or the liquidator to prefer an application before court of competent criminal jurisdiction. For enforcement of the criminal action the official liquidator shall seek the permission of the tribunal to prosecute the guilty person by filing an application before it.[48] If it has been found that the parties involved has indulged in fraudulent conduct of business the tribunal may permit the official liquidator or liquidator to move the court of criminal jurisdiction for appropriate order to ensure punishment provided under the Act.

The following are the pertinent questions to be addressed before fixing the charge of fraudulent trading on any corporate officer. Firstly, who are the persons subject to a duty to prevent fraudulent trading? Secondly, what is the degree of knowledge and involvement necessary to make a person liable for fraudulent trading? Thirdly, what are the other conditions to be satisfied before initiating prosecution for fraudulent trading? These issues are analysed in the following paragraphs.

A. PERSONS WHO CAN BE MADE LIABLE FOR THE OFFENCE

'Any person who is knowingly a party to the carrying on of the business of the company' with the intent to defraud the creditors of the company or for any fraudulent purpose is liable to be punished for the offence of fraudulent trading. Courts in India, while interpreting the provision, have held that persons who are not actively involved in the management of the company cannot be parties to the carrying on of business with intent to defraud.

In *Sandal Chit Fund Financiers Ltd.* v. *Narinder Kumar Sharma*,[49] the court dismissed the petition filed against the directors of the company for fraudulent trading on the ground that there was no allegation against the directors that they were actively running the affairs of the company. The court held that to establish liability against the respondents specific allegations are to be raised against him. Where there is no specific allegation against a particular director, he cannot be made liable for fraudulent trading.

In *Re*: *Popular Bank Ltd*. (*In Liquidation*)[50] proceedings for fraudulent trading were initiated against the directors of the bank for being parties

[47] Hema v. M. Muthuswamy, Administrator, RPS Benefit Fund Ltd. (In Liquidation), (2007) 139 CompCas 214 (Mad)

[48] The Companies Act, 1956, §457(1)(a).

[49] (1994) 79 CompCas 25 (P&H).

[50] AIR 1970 Ker 120.

to covering up the fraud committed by causing false and fictitious entries in the books of the bank by the managers . The respondents contended that they were not in the executive committee at the relevant period and that they placed implicit trust and confidence in the managers and in the members of the executive committee to whom the power of managing the affairs of the bank had been delegated, and that they cannot be held responsible if things went wrong. The court observed that irrespective of the size and standing of the bank, the volume of business transacted therein, and the efficiency and trustworthiness of the persons to whom responsibilities were entrusted directors had a duty to ensure that the executive committee functioned properly and discharged their functions satisfactorily.

The directors of the board should be brought within the broad ambit of 'parties to the carrying on of the business of the company'. Even though it may seem to be an interpretation in wide terms, this may be necessary in the larger interest of the company. The delegation of the whole duty of management to managers should not absolve the duty of directors to properly monitor the conduct of such officers. In the light of the duty of the board of directors to oversee and supervise managers, laxity of supervision can be a ground for imposing liability for fraudulent trading. Where fraudulent activities are carried on for a long period of time the board of directors are equally responsible to see that the fraud is checked at the earliest and that rescue operations are carried out. The basis of criminal liability of the director for fraudulent trading would be a criminal omission on his part to monitor and supervise the managers. On the other hand the basis of criminal liability of the manager for fraudulent trading would be his own acts of commission resulting in corporate insolvency.

B. INTENTION TO DEFRAUD

If, on an assessment of all the facts and circumstances, the fraudulent intent or the fraudulent purpose is made out, then liability must follow. The intention to defraud may be inferred from the conduct of the accused persons. The transactions entered into during the period when the company was in financial distress are examined for the purpose. Intention to defraud can be established if it can be shown that any debt was incurred or if the company has entered into any non-commercial transactions during the period of financial difficulties. A company can be said to be in financial difficulties if it has an excess of liabilities over its assets.

In *Official Liquidator* v. *Ram Swaroop*,[51] the statement of affairs filed with the official liquidator showed that the ex-directors had withdrawn huge amounts of money as interest free loan but had not been returned it to the company despite the fact that the financial condition of the company was

[51] AIR 1997 All 72.

in a dire state and huge amounts were due towards income tax, provident fund of the workmen and other dues. The court found that had the ex directors not misapplied the funds of the company by holding them over for their benefit without paying any interest thereon the company probably would not have had to face liquidation. The court held that where the directors of the Company had unjustifiably withdrawn huge amounts out of the capital of the company and continued to carry on the business of the company even after knowing fully well that the company is running at a loss and was unable to pay its dues, it would be sufficient to charge them with liability for fraudulent trading.

In *South India Paper Mills Pvt. Ltd* v. *Sree Rama Vilasam Press Publications*,[52] the court applied the litmus test of whether the directors of the company were aware, at the time the purchases were made, that there was no reasonable prospect of repayment at all. The court observed that "A company may actually be insolvent at a given time; but its directors may *bona fidely* hold a different view. Even in a case where they are aware of the true position, they may still think that all was not lost and that they would be able to stem the rot by further borrowings and improving the business."[53] If the directors had acted on a *bona fide* belief of rescuing the company then they cannot be made liable for the offence of fraudulent trading. [54] Here again we find that the court attaches much significance to the state of mind of accused persons. This may ultimately lead to a situation where it is possible for every accused person to escape liability by pleading that he had acted in a *bona fide* manner on the belief that by entering into the transaction the company would ultimately be saved. He is excused if it is shown that the additional credit was incurred on the belief that prosperity would return. It is suggested that a better approach would be to adopt an objective standard in determining whether the transactions in issue were entered into with intent to defraud. The enquiry should be whether a reasonable man aware of the precarious condition of the company would enter into the transaction. Law should reduce all incentives to gamble with the creditor's money by imposing liability for actions which seriously prejudice the interests of the creditors.

In *Hypine Carbons Limited* v. *J.C. Bhatia*[55] the court held that the mere failure to initiate legal steps against the debtors of the company for the

[52] (1982) 52 CompCas 145 (Ker).

[53] *Id*., 147.

[54] The facts of the case are as follows: The company in liquidation was a printing and publishing concern. The present application was filed by one of the creditor for a declaration that the directors were liable to pay the debt owed to him. The applicant was supplying paper to the company. The allegation against the directors was that the company was obtaining credit facilities after stoppage of business and commencement of winding up proceedings. Supplies were obtained without disclosing the above facts. The Court held that carrying on of business after the presentation of a winding-up petition, without disclosing the pendency of the proceedings cannot by itself be presumed to be fraudulent.

[55] (2001) 103 CompCas 422 (HP).

recovery of the amounts due from them would not make the respondents liable for fraudulent trading unless it is shown that the respondents had failed to do so with fraudulent intentions to defraud the creditors, or any other person, or for any other fraudulent purpose.

Thus one can find that intention to defraud is very difficult to make out. To establish the offence of fraudulent trading actual dishonesty has to be proved.

C. WHEN CAN PROSECUTION BE INITIATED?

Criminal proceedings under §542(3) will lie only if the court/ tribunal has passed an order under §542(1) that the persons concerned have indulged in fraudulent trading.[56] Ordinarily the proceedings under §542 are initiated after determining the value of the assets of the company and the extent of its liabilities on the basis of the statement of affairs submitted in accordance with the provisions of the Act and preparation of the list of creditors. The provisions use the expression "if it appears in the course of winding up" indicates that if some disclosure is made in the course of winding up from which it appears that the business was carried on in a fraudulent manner the proceedings could be initiated.

A declaration that the persons concerned have indulged in fraudulent trading is a precondition for initiation of criminal proceedings. The declaration can be made only if winding up proceedings are completed. If the company has somehow or the other survived the crisis, then the question of examining the conduct of directors would not arise. This rule would not go in tune with the duty of directors to take care of the interests of the creditors when the company is in financial difficulties. The requirement of the event of liquidation and a declaration that the persons concerned have indulged in insolvent trading as a precondition to the initiation of criminal proceedings is not desirable. The law as it stands today is that once the company has overcome its financial difficulties and has become a growing concern, the persons in charge of the business cannot be prosecuted for indulging in fraudulent trading. The defendant can be lawfully convicted only if the company in question is wound up. The rationale seems to be that once the company has survived the crisis there is no need for the officers to be prosecuted. The duty to prevent insolvent trading shall impose a positive duty to avoid carrying on business in a manner likely to cause substantial risk of serious loss to the company and the creditors. To enhance the deterrent value of the provision, the necessity of a declaration that the persons concerned has indulged in insolvent trading many be dispensed with.

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[56] *Supra* note 35.

VI. ENGLISH LAW

The Companies Act, 2006 penalizes persons knowingly taking part in carrying on a company's business with an intention to defraud creditors.[57] The punishment for the offence has been enhanced to ten years of imprisonment and fine from that of seven years and fine under the old Act.[58] Under the Companies Act, 1985 also fraudulent trading was a criminal offence.[59] Every person who was knowingly a party to the carrying on of the business with intent to defraud creditors or for any fraudulent purpose is liable on conviction to imprisonment for a term of seven years.[60] The civil remedy for fraudulent trading is provided under the Insolvency Act, 1986.[61] To establish the offence of fraudulent trading the prosecution has to prove the following facts.

A. PARTICIPATION IN THE CARRYING ON OF THE BUSINESS

Firstly, the prosecution has to prove that the defendant took an active part in the carrying on of the business. Under the English law 'every person who is a party to the carrying on of the business of the company' has a duty to avoid fraudulent trading. The term 'party to the carrying on of the business of the company' has been interpreted to encompass the managers and officers of the company having managerial powers and any other person involved in the fraudulent acts.

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[57] The Companies Act, 2006, §993; Offence of fraudulent trading (1) If any business of a company is carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, every person who is knowingly a party to the carrying on of the business in that manner commits an offence.

(2) This applies whether or not the company has been, or is in the course of being, wound up.

(3) A person guilty of an offence under this section is liable– (a) on conviction on indictment, to imprisonment for a term not exceeding ten years or a fine (or both); (b) on summary conviction– (i) in England and Wales, to imprisonment for a term not exceeding twelve months or a fine not exceeding the statutory maximum (or both); (ii) in Scotland or Northern Ireland, to imprisonment for a term not exceeding six months or a fine not exceeding the statutory maximum (or both).

[58] *Id*.

[59] The Companies Act, 1985, §458, Fraudulent trading by a Company; If any business of a company is carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, every person who was knowingly a party to the carrying on of the business in that manner is liable to imprisonment or a fine, or both. This applies whether or not the company has been, or is in the course of being, wound up.

[60] Id.

[61] The Insolvency Act, 1986, §213; (1) If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.

(2) The court, on the application of the liquidator may declare that any persons who were knowingly parties to the carrying on of the business in the manner above-mentioned are to be liable to make such contributions (if any) to the company's assets as the court thinks proper.

In *Re*: *Maidstone Buildings Provisions Ltd*.,[62] the Court of Chancery Division interpreted the term 'party to the carrying on of the business of the company' under the corresponding provision of the old Act. The liquidator brought proceedings against the company secretary under §332 of the Companies Act, 1948 for having failed to advise the directors that the company was insolvent and should cease to trade. It was held that a company secretary was not to be included among 'parties to the carrying on of the business with intend to defraud creditors'. In order to be a party to the carrying on of the business a person must have taken some positive steps. Mere inertia was not enough. The allegation against the defendant was only that he omitted to steps to prevent the company trading fraudulently. He was not concerned with the management of the company and hence he cannot be made liable. Mere silence and omission cannot make him a party to the carrying on of the business of the company. There was nothing on record to prove that the secretary was involved in the management of the company. Lack of managerial powers prompted the court to absolve the liability of the defendant.

In *Re*: *Gerald Cooper Chemicals Limited* (*in Liquidation*),[63] a creditor was found liable for the offence of fraudulent trading. The creditor had accepted money from the company which he knew had been obtained by fraud on another creditor. Templeman J. said: "In my judgment, a creditor is party to the carrying on of a business with intent to defraud creditors if he accepts money which he knows full well has in fact been procured by carrying on the business with intent to defraud creditors."

The meaning of the term 'parties to the carrying on of the business' as it appears in §213 of the Insolvency Act, 1986 was discussed in *Morris* v. *Bank of India*[64] wherein it was held that the term is wide enough to cover outsiders who in some way or the other participated in the fraudulent acts.[65]

It is doubtful whether English law allows the directors of the company to be made liable for fraudulent trading unless they occupy some

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62 [1971] 3 All ER 363.

63 [1978] 2 All ER 49.

64 [2004] 2 BCLC 279.

65 The facts of the case is as follows: The liquidators of BCCI brought proceedings against the defendant bank (BOI), alleging that BOI had knowingly participated in the carrying on of BCCI's business for a fraudulent purpose or with the intent to defraud BCCI's creditors .Transactions between BCCI and BOI enabled BCCI to conceal bad debts from its auditors and to conceal the fact that it was insolvent. BOI provided loan facilities for a number of companies at BCCI's request. BCCI made equivalent deposits with BOI and guaranteed the loans. BCCI concealed its liabilities to BOI when preparing the accounts. BOI denied having any knowledge that it had participated in the fraud. To establish the case against the defendant the liquidators had to prove that BOI, through its relevant officers and employees, had knowledge that the transactions were for a fraudulent purpose. The court held that it was not necessary that such persons knew the details of the fraud, but rather that they knew that a fraudulent activity was taking place with a view to defrauding someone or for a fraudulent purpose.

managerial position and are actively involved in the carrying on of the business of the company. Thus the Indian law and the English law with respect to the question of persons subject to the duty to prevent fraudulent trading seems to be the same.

B. INTENTION TO DEFRAUD CREDITORS

Fraud or fraudulent purpose under the fraudulent trading provision has been interpreted as meaning 'actual dishonesty according to current notions of fair trading'.[66]

Intention to defraud creditors is an essential element of the offence of fraudulent trading. An intention to defraud creditors can be inferred if there was dishonesty involving real moral blame according to current notions of fair trading. In *R* v. *Grantham*,[67] it was held that where a person takes part in the management of a company's affairs and obtains credit for the company when he knows that there is no reason for thinking that the funds will become available to pay the debt when it becomes due, he can be found guilty of an offence of carrying on the company's affairs 'with intend to defraud creditors of the company'. For a person to be found guilty of the offence it is not necessary for the prosecution to prove that there was no reasonable prospect of the company's creditors ever receiving payment of their debts. It is immaterial that only one creditor has been defrauded and by only one transaction, provided that the transaction can properly be described as fraud on the creditor perpetrated in the course of carrying on the business.[68]

There is an intention to defraud the creditor either if the debtor intends that the creditor shall never be paid or if he carries on obtaining credit when the rights and interests of the creditor are prejudiced in a way generally regarded as dishonest. An intention to defraud creditors can be inferred in circumstances where the company carries on the business and incurs debts when to the knowledge of the directors there is no reasonable prospect of the company being able to pay them. The prosecution has to prove that the defendant knew or ought to have known that there was no reasonable prospect of the company being able to clear the debts.

C. DEFENDANT WAS ACTING DISHONESTLY

Thirdly, the prosecution has to prove that the defendant was acting dishonestly. There must be a finding of dishonesty for the criminal offence to be committed.[69] The defendant can be said to have acted dishonestly and

[66] In Re: Patrick & Lyon Ltd., [1933] I Ch 786, 790.
[67] [1984] 3 All ER 166.
[68] In Re: Gerald Cooper Chemicals Ltd., [1978] 2 All ER 49.
[69] R. v Cox [1983] BCLC 169.

fraudulently if he realized at the time when debts were incurred that the company will never be able to meet its liabilities as they fall due. Where a company is seen to have carried on business and incurred debts at a time when, to the knowledge of the persons concerned, there was no reasonable prospect of the creditors ever having received payment of those debts, an inference to defraud can be drawn.[70] The court has to find that the directors were acting dishonestly, not just that they were acting unreasonably.[71] Difficulty arises in proving that the persons concerned had the knowledge that there was no reasonable prospect of making payment of the debts. The difficulty of establishing dishonest intention has made the remedy little used.[72] Incurring more and more debts to the prejudice of the creditors in circumstances where there were no reasonable prospects of success amounts to fraudulent and dishonest act.

D. WHEN CAN THE PROSECUTION BE INITIATED?

Under the old Act prosecution for the offence of fraudulent trading could be initiated only if an order had been passed that the persons involved has indulged in trading with intend to defraud creditors or for any fraudulent purpose.

In *DPP* v. *Schildkamp*,[73] the House of Lords considered the issue of whether before any person can be prosecuted for the commission of an offence of fraudulent trading, the company referred to must subsequently have been put into liquidation. The House of Lords answered the question in the affirmative on the ground that the offence of fraudulent trading applied only to acts done before or in the course of winding up. Since in the present case the company in question had never been wound up, the defendant was acquitted even though he pleaded guilty to the charge. In *R* v. *Rollafson*,[74] the Court of Appeal took a similar stand and quashed a conviction for fraudulent trading on the ground that the offence was intended to cover acts committed before or during a winding up. Both the above cases dealt with liability for fraudulent trading under §332 of the Companies Act, 1948.

Under the 2006 Act, criminal proceedings can be initiated whether or not winding up proceedings are initiated. Cl. (2) of §993 of the Companies Act, 2006 reads as follows: "This applies whether or not the company has been, or is in the course of being wound up". The new provision is to be hailed because fraudulent trading ought to be actionable irrespective of whether the company is ultimately wound up or not so as to deter the directors from indulging in reckless trading. This alone would make the duty to prevent

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70 In Re: William C. Leitch Bros. Ltd. [1932] 2 Ch 71 (Ch. D).
71 In Re: L. Todd (Swanscombe) Ltd., (1990) BCC 125.
72 Dr. Janet Dine, *"Punishing Directors"*, 1994 J.B.L. 325 at p. 333.
73 [1969] 3 All ER 1640 (HL).
74 [1969] 2 All ER 833 (CA).

fraudulent meaningful. This does not mean that every venture involving a risk has to be avoided by the directors .The directors of companies who abuse the facility of limited liability and indulge in reckless trading should be made accountable for the same. The fact that the company ultimately survived the financial crisis shall not be a ground for discharging the directors of their liability for fraudulent trading. The offence should be made actionable by the regulatory authorities. Only then would the fraudulent trading provision be able to play a role in preventing corporate failures.

An analysis of the fraudulent trading provisions the UK would show that a heavy burden is cast on the prosecution to prove fraud and dishonesty to the standard of proof required by criminal law. This diminishes the availability of the remedy. There have been only a few reported cases involving director liability for fraudulent trading.[75] There is no accountability in the real sense because liability is incurred only if it is proved that the persons concerned had knowingly committed the offence. The law as it exists fails to address negligence or failure to take proper action on the part of managers and directors of the company.

VII. CONCLUSION

A review of the fraudulent trading remedy in India would reveal that its effectiveness is considerably weakened by the conditions that have to be satisfied for its application. Firstly, liability can be imposed only on "persons who were knowingly parties to the carrying on of the business". Secondly, the business of the company must have been carried on with intend to defraud creditors of the company or for any fraudulent purpose. Thirdly, there has to be declaration from the tribunal that the persons concerned has indulged in insolvent trading.

To conclude, it can rightly be said that in reality fraudulent trading provisions have failed to achieve their objective of providing an efficient mechanism to penalize fraudulent trading activities of managers and directors. There are both substantive and procedural problems involved in the enforcement of these provisions. The substantive difficulties are on account of proving the ingredients of the offence especially because proving the offence beyond reasonable doubt. The procedural problems arise on account of the conditions to be satisfied for initiating the prosecution. The provision remains as a mere paper tiger and does not address the issue of accountability for fraudulent acts. Reforms are necessary to enhance directorial performance and to prevent corporate failures. Appropriate amendments are necessary to make the offence easier to establish. It is suggested that the standard of proof required to establish the offence be lowered. The directors have a duty to be informed under the

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75 Cheffins, *supra* note 7, 547.

duty of care owed by directors. Directors are bound to be aware of the financial condition of the company and if they fail to take active steps to recover a company in financial distress, the law should make them responsible for the same. Corporate failures can cause massive external costs on the economy as a whole and hence the legal system should have an effective system of punishing rogue managers as well as lax directors. Rather than waiting for an Indian episode of Enron to happen the legislators should rise up to the occasion and the Companies Act, 1956 should be suitably amended so as to enable the regulatory agencies to commence a fraudulent trading action irrespective of whether the company fails or not. If companies are to survive and flourish as a business model for profit making, creditor protection ought to be the main concern of the regulatory mechanism. If not, there would be no one to advance debt finance to companies. Proscribing fraudulent trading would become meaningless unless the provisions are suitably modified to facilitate efficient enforcement.